

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)
)
Annual Assessment of the Status of) CS Docket No. 98-102
Competition in Markets for the)
Delivery of Video Programming)
)

COMMENTS OF A&E TELEVISION NETWORKS
TO
NOTICE OF INQUIRY

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SUMMARY

Television audiences expect programming networks to create and acquire high quality programs. This expectation requires cable networks to expand their investments in programming if they are to stay competitive in an increasingly crowded media environment. The audience demand for higher quality fare never diminishes -- it only expands -- and at the same time, more programming networks must bid for the same pool of talent, which consequently increases the price of that talent. Policies that focus only on the issue of costs, and limit the ability of programming networks to improve their value to subscribers, inevitably shortchange the audience, as the Commission found in its earlier experience with rate regulation. Moreover, regulation that ignores the many factors that contribute to cable rates changes and focuses only on programming costs will jeopardize the continuation of the quality programming on cable services that initially attracted the consumers to cable.

The cable industry also needs to be able to rely on the ability of operators to package programming in tiers if programmers are to continue to risk the resources necessary to launch new networks or to develop innovative niche programming. Packaging programming, like packaging the volumes of an encyclopedia or sections of a newspaper, helps to ensure networks of some return on their large upfront investments in operating, programming, personnel and equipment costs. Accordingly, the existing structure of the cable programming market is critical to the economic viability of programming services and has resulted in significant improvements in the quality and availability of programming to consumers.

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To the Commission:

NOTICE OF INQUIRY

A&E Television Networks (including the A&E Network and The History Channel) ("AETN"), by its attorneys and pursuant to Section 1.415 of the Commission's rules, 47 C.F.R. § 1.415, hereby submit comments in response to the *Notice of Inquiry 1/* in the above-captioned proceeding (the "*Notice*").

A&E Television Networks is a cable programmer that is neither owned nor controlled by any cable operator. It offers both the A&E Network ("A&E"), an established cable network, and a newer service, The History Channel. A&E is currently delivered to more than 71 million cable households throughout the country via cable, TVRO, MMDS, DBS, and SMATV distribution systems. 2/ It features critically acclaimed original entertainment programming, including the series BIOGRAPHY®, mysteries, dramatic and documentary programs and

1/ *Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, FCC 98-137, CS Docket No. 98-102 (rel. June 26, 1998).

2/ See Paul Kagan Associates, Inc., Cable Program Investor at 19 (June 12, 1998) ("June 1998 Study").

specials. Over 80 percent of A&E's prime time schedule consists of original productions. In addition, *A&E Classroom* was cited by Vice President Al Gore for its innovative, and educational role in supporting Cable in the Classroom. ^{3/} On January 1, 1995, AETN launched The History Channel. The History Channel is a unique, high-quality programming service featuring historical documentaries, movies and miniseries placed in historical perspective. Audiences have responded to the quality nature of the programming: History has over 50 million subscribers. ^{4/}

The Commission recognized in the *Notice* that any analysis of the video industry must consider the economics of the cable programming market. The *Notice* explicitly sought information as to whether changes in cable rates are "attributable to increases in programming costs," on the economic, competitive, legal and technical considerations that lead to the creation of programming tiers. ^{5/} Based on recent studies, and AETN's own experiences with both an established and emerging network, increases in the costs of general entertainment programming have not been the primary cause of rate increases. Additionally, the existing structure of the cable programming market, in which there is flexibility in determining how programming services should be packaged, is critical to the economic viability of niche programming services and has resulted in significant improvements in the quality and availability of programming to consumers.

^{3/} Remarks of Vice President Al Gore, National Cable Television Association Convention, Los Angeles, California, April 29, 1996.

^{4/} See June 1998 Study at 19.

^{5/} *Notice* at ¶ 7.

I. ANY INQUIRY INTO PROGRAMMING COSTS AS A FACTOR IN CABLE PRICES ALSO MUST CONSIDER THE VALUE OF PROGRAMMING TO SUBSCRIBERS.

To whatever extent programming costs may contribute to cable prices, no inquiry is complete unless it also considers the value of programming to consumers. Television audiences expect programming networks to create and acquire high quality programs. This expectation requires networks to expand their investments in programming if they are to stay competitive in an increasingly crowded media environment. The audience demand for higher quality fare never diminishes -- it only expands -- and at the same time, more programming networks must bid for the same pool of talent. Policies that focus only on the issue of costs, and limit the ability of programming networks to improve their value to subscribers, inevitably shortchange the audience, as the Commission found in its earlier experience with rate regulation. 6/

The quality of programming on cable television is demonstrated by trends in audience preferences. From May 25 to July 12 of this year, prime time ratings for cable television, as a whole, have risen about 11 percent -- to 10.4 -- among adults 18-49 compared to the same period last year. 7/ Better original programming is the leading cause of such a marked increase, 8/ and the ultimate

6/ See Nickolas Davatzes, *Quality Cable at Risk*, Washington Post, April 27, 1994 (attached). See also, Thomas W. Hazlett, *Explaining the Telecommunications Act of 1996*, 29 CONN. L. REV. 217 (Fall 1996).

7/ See Broadcasting & Cable at 46 (July 20, 1998).

8/ See *id.*

result is a more satisfied viewing public. Additionally, this original and niche programming increasingly has been recognized as the type and quality of fare that the Commission considers as serving the public interest. 9/

Maintaining the quality of cable programming, however, is not an easy task. More than ever before, a growing number of bidders are seeking the talent required to make quality programming. The number of national broadcast networks has more than doubled during the past decade. From 1993 to 1996, the number of basic cable networks has increased from 72 to 126 -- a rise of 75 percent. 10/ As more and more entertainment outlets -- which include not only the growing number of broadcast and cable networks, but also cinematic and direct-to-video producers -- compete for the limited number of writers, directors, performers and producers able to create quality programming, such talented creators can command higher fees, and many already have done so. AETN itself has seen program licensing and production costs increase, on average, over 20 percent annually over the last five years. Cable programmers thus must have sufficient resources to be able to bid against its programming competitors for this talent. Without such resources, cable programmers will lose access to the innovative creators that have made their

9/ See Eli Noam, *Public Interest Programming by American Commercial Television* (March 1998).

10/ Compare *Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, 9 FCC Rcd 7442 (¶ 21) (1994) with *Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, FCC 97-423, CS Docket No. 97-141 (¶ 19) (released January 13, 1998).

programming preferred by a large (and increasing) number of viewers, which has in turn enabled them to obtain the licensing fees they needed to develop additional quality programming.

Such licensing fees -- which ensure a reliable income stream whatever the vagaries of the advertising market -- continue to be the life blood of cable programming services because they ensure at least some return on the heavy, upfront programming investments that are required to make a network competitive. On average, even cable networks with more than 60 million subscribers invested more than 40 percent of their revenues on programming in 1997. ^{11/} Smaller networks' investments in programming were even more substantial: networks of 45 to 60 million subscribers spent, on average, nearly 50 percent of their revenues on programming, and networks of 30 to 45 million subscribers spent more than 100 percent of their revenues on programming. ^{12/} As this data demonstrates, cable networks of all sizes recognize that quality programming is critical to a successful network; however, unless a network receives sufficient licensing fees to underwrite its ability to afford such programming, the network will not be able to survive.

^{11/} See June 1998 Study at 10.

^{12/} See *id.* It should be noted, however, that such heavy investment in programming is not a result of rising programming costs, but simply a requirement of a successful network. In fact, as compared to 1994, program spending as a percentage of network revenues has declined for the large majority of cable networks. See, e.g., *id.* (noting that programming costs in 1997 as a percentage of revenues for networks with 45 to 60 million subscribers declined 23 percent and for networks with 30 to 45 million subscribers, 115 percent, since 1994).

Any reduction in the ability of cable operators to pass through costs of programming will have additional ramifications in light of the advent of digital cable. Digital cable is intended to foster new networks, which, in time, will require additional programming to continue to grow and prosper. Unless programmers are assured of the viability of licensing fees, they will lack the ability to create that new programming. New digital networks -- like all new networks -- will be unable to ensure that viability unless they can pass through such costs to their subscribers: as noted, in 1997, basic cable networks with fewer than 45 million subscribers already spent more than 100 percent of their total revenues on programming. ^{13/} In light of such existing (and justifiable) programming expenses, new networks will prove increasingly unable to sustain quality programming on any long-term basis without the ability to pass through some of its costs to the programming's potential consumers. The Commission's inquiry should therefore consider the value to the consumer that flows from the ability of networks to pay for quality programming and to launch new services.

^{13/} June 1998 Study at 10.

II. WHILE CABLE PROGRAMMING COSTS ARE INCREASING DUE TO MARKET DEMANDS, SUCH CHANGES ARE ONLY ONE CAUSE OF CABLE PRICE INCREASES.

Although there has been an increasing amount of attention devoted to programming costs in the past year, as witnessed by the Notice, changes in programming costs are not the sole component of cable price increases to consumers. For example, in its most recent *Report on Cable Industry Prices*, the Commission noted that cable rates respond to the costs of several distinct elements.^{14/} The Cable Price Report found that equipment costs, system upgrades, channel additions, programming fees and inflation all contributed to increases in cable rates.

Of the various components of cable television rates, the Cable Price Report suggests that programming fees have been declining in significance. As one element of its analysis, the Report surveyed 466 noncompetitive cable systems and asked each why they changed their cable rates. Between 1995 and 1996, the systems cited inflation as the cause of 35 percent of their rate changes and changes in programming costs as the reason for 37 percent of such changes. Between 1996 and 1997, however, the percentage of rate changes because of inflation remained roughly constant among these systems, but the percentage of instances in which a rate change was attributed to programming costs actually fell to 29 percent. Thus, even among noncompetitive cable systems, programming

^{14/} See *Statistical Report on Average Rates for Basic Service, Cable Programming Services, and Equipment*, MM Docket No. 92-266, FCC 97-409 (rel. Dec. 15, 1997) ("Cable Price Report").

fees were found to be a less significant factor in changing cable rates (by more than 20 percent) in 1997 as compared to 1996. ^{15/} Such decline suggests that the policymakers should not seek to make programming costs the scapegoat for increases in cable rates.

A separate study, released March 1998 by Kagan & Associates, Inc., also suggests that changes in programming fees are not primarily responsible for increases in cable rates. The study notes that basic cable networks actually have received a slightly smaller percentage of their revenues from licensing fees since 1993. ^{16/} If cable networks are receiving less of their income through licensing fees, those licensees are paying, in percentage terms, less of the real value of the programming carried on those networks. Accordingly, both this and the Commission's study indicates that cable rate changes occur for many reasons unrelated to programming fees.

^{15/} See Cable Price Report at 11.

^{16/} See Paul Kagan Associates, Inc., Cable Program Investor (March 13 1998), at 2 ("March 1998 Study") (showing a decline, as a percentage of basic cable network revenues, in license fees from 40.8 percent in 1993 to 39.4 percent in 1997).

III. IN A CABLE ENVIRONMENT, THE ABILITY TO MARKET PROGRAMMING IN TIERS IS NECESSARY TO MAKE MANY CABLE NETWORKS ECONOMICALLY FEASIBLE.

There have been recent claims that consumers are not served by marketing cable channels in tiers. ^{17/} Perhaps as a result, the *Notice* attempts to confirm whether such packaging of programming remains consistent with the public interest. In fact, as in years past, the ability to market a number of networks within a single tier benefits consumers and ensures better programming.

The cable industry, as in other media, need a certain opportunity for return on any investment in content and a certain market reach. For example, an encyclopedia publisher is not required to sell each volume of a set of encyclopedias individually. Such an à la carte scheme would hardly be the most efficient means of providing quality encyclopedias to consumers, as encyclopedia publishers might choose to increase the costs of the most well-read volumes in order to subsidize production of "niche" volumes like Q or X -- or might choose to stop publishing such niche volumes entirely. Similarly, a newspaper could not be expected to sell its news section separate from its sports or style section, as such fragmented sales would likely result in limited numbers of consumers and advertisers for each of these sections, which in turn would limit the quality of each section, as well as limit the ability of the publisher to test new sections -- such as periodic Books or Travel inserts -- as potential new outlets for information or entertainment.

^{17/} Statement of Chairman Kennard, *Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, FCC 97-423, CS Docket No. 97-141 (released January 13, 1998).

The same economic considerations apply to the market for programming services. Like encyclopedia publishers, cable programmers are far less likely to offer niche services if they cannot rely on some assurance that a broader audience will purchase these services. Moreover, like newspaper publishers, cable programmers must attain a certain number of subscribers for programming -- both established and novel -- to attract the advertisers a network needs to survive. 18/

Tiers enable an operator to package new or niche programming with established programming -- thus broadening a new service's potential audience -- while enabling established networks to maintain the subscribership necessary to attract advertisers. First, the packaging of programming better enables an operator to carry -- and a programmer to sell -- innovative or enriching programming that consumers may value, but that would not be economically feasible or immediately attractive to consumers if sold independently. Interference with the ability to tier programming would make developing novel or niche programming more risky, as programmers (or operators) would have to be willing to absorb the huge upfront

18/ The June 1998 Study confirms this analysis. In 1997, cable networks with over 60 million subscribers generally received more than \$3.50 of ad revenue for every subscriber. *Id.* at 8. But cable networks with subscribership between 30 and 45 million received only 89 cents of advertisements per subscriber, with smaller networks even receiving lower advertising amounts. Such numbers demonstrate that any disruption to the ability of networks to maintain subscribership drastically diminishes the advertisers' contribution to a network's ability to invest in better or innovative programming.

costs of starting (or paying the license fees for) a new network without being assured some initial audience.


Second, program tiers reasonably assure advertisers and cable networks alike that a network will not suffer significant short-term disruptions in its existing subscribership. Paul Kagan Associates has estimated that a 10 percent drop in penetration for even an established cable programming service would lead to a reduction in cash flow by two-thirds, while a 25 percent drop in audience reach "could theoretically wipe out cash flow." Because "[t]he average network spends virtually 100% [of] network ad revenue on programming . . . especially [on] costly original productions," even a small reduction in penetration would force an established cable programmer to reduce spending on the production of new programming.^{19/} And, alternatively, such a reduction would put upward pressure on licensing fees to make up for lost advertising revenue. According to the Subscriber Study, the result would be "a damaging chain reaction" that "could negatively affect program budgets, resulting in homogenization of cable

^{19/} Paul Kagan Associates, Inc., Cable TV Programming (March 23, 1993), at 1-2 ("Subscriber Study").

programming and fewer choices for the cable consumer." 20/ In other words, the elimination of tiers would introduce new and dangerous uncertainties in the cable advertising and programming markets, which in turn would risk the increasing quality of diverse programming available on today's cable networks.

Respectfully submitted,

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20/ *Id.*

Nickolas Davatzes

Quality Cable at Risk

The Washington Post

The Federal Communications Commission recently unveiled details of another round of cutbacks in the rates for cable television services—the second in five months. These rollbacks will unquestionably hinder the industry's ability to invest in new technologies and programming and create jobs.

The process was designed to regulate cable operators, but the government unfortunately delivered a bombshell. Cable operators have been loudly protesting these additional rate reductions, and justly so. But the unintended victims of the FCC action are the cable programmers, who today find themselves confronting an uncertain and difficult future.

My firm, A&E Television Network, delivers critically acclaimed entertainment programming featuring original biographies, mysteries and specials to more than 58 million cable households. We are proud that A&E is among both the most popular and the most honored cable services; the network has received more CableACE awards than any other basic cable network.

This fall, we are scheduled to launch a new programming service, the History Channel, which will feature historical documentaries, movies and miniseries. Independent research has indicated that among consumers the History Channel is the most eagerly awaited programming service on the horizon. Now, both the continued success of A&E and other established cable networks and the launching of new services such as the History Channel are at risk because of the latest set of government regulations on cable television.

Like A&E, many cable programmers have seen their plans for improvement and expansion come to an abrupt halt as they wonder whether cable operators will still have the incentive to continue to add new networks to their channel lineups. Today it appears that the new cable regulations will actually discourage cable companies from offering consumers new channels.

There is another problem for companies like ours. Programming costs in the United States and around the world have continued to grow at a rate greater than inflation, and they account for an ever-increasing proportion of our operating budgets.

A&E made a significant incremental investment in programming for 1994. Based upon the guidelines handed down by the FCC last year, we had planned to recover a substantial portion of these expenses from the cable operators who pay our service. But now the FCC has altered the landscape by reducing rates an additional 7 percent. The ability of cable operators to pay network fees, which reflect increased programming

costs, has been greatly compromised by the government-imposed rate reductions that now amount to 17 percent of their revenues.

Furthermore, these new regulations may make it economically unfeasible for cable companies to add new networks to their regulated package of service. This would be a tremendous blow to the 50 new program networks now underway, the History Channel among them. This is

"Should every exit on the information superhighway lead to home shopping?"

the bottom line: Without proper incentives for cable operators to expand their programming, we may have already seen the last new cable programming network of value. Should every exit on the information superhighway lead to home shopping?

The FCC, fortunately, has indicated that it wants to promote the development of new entertainment and information cable networks. The question today is whether the government will allow adequate incentives for cable operators to accept both the capital and operating costs associated with expanded channel lineups for programming networks of consumer value. We hope these incentives will be available, but in the meantime, we can do little but wonder what the future holds—and whether ventures like the History Channel will have one.

A&E and the History Channel are programming entities, without any ownership by cable operators. Our company was not among those Congress intended to regulate when it passed the Cable Act of 1992. It is therefore unjust for the federal government to punish A&E and other companies like it, which at every turn are praised by consumers, the media, educators and elected officials for delivering real value for the price.

What consumers demand is quality entertainment and information cable programming. If that programming is made to suffer as a consequence of new regulations on cable operators, then the government will have missed its mark and threatened the health of one of our most exportable products. In the end, the continued quality and diversity of cable programming will be the ultimate measure of the success of cable regulation.

The writer is president and CEO of A&E Networks.